II. THE ANTICOMPETITIVE IMPACT OF HORIZONTAL, VERTICAL AND CONGLOMERATE MERGERS INVOLVING DOMINANT FIRMS

A. THE OVERALL APPROACH TO THE ANALYSIS

This analysis relies on the structure, conduct performance (SCP) view of economic activity.[62] Exhibit 5 presents the factors identified as playing an important role in the paradigm.[63] The SCP approach has been the dominant public policy paradigm in the United States for the better part of this century.[64] The elements of the approach can be described as follows.

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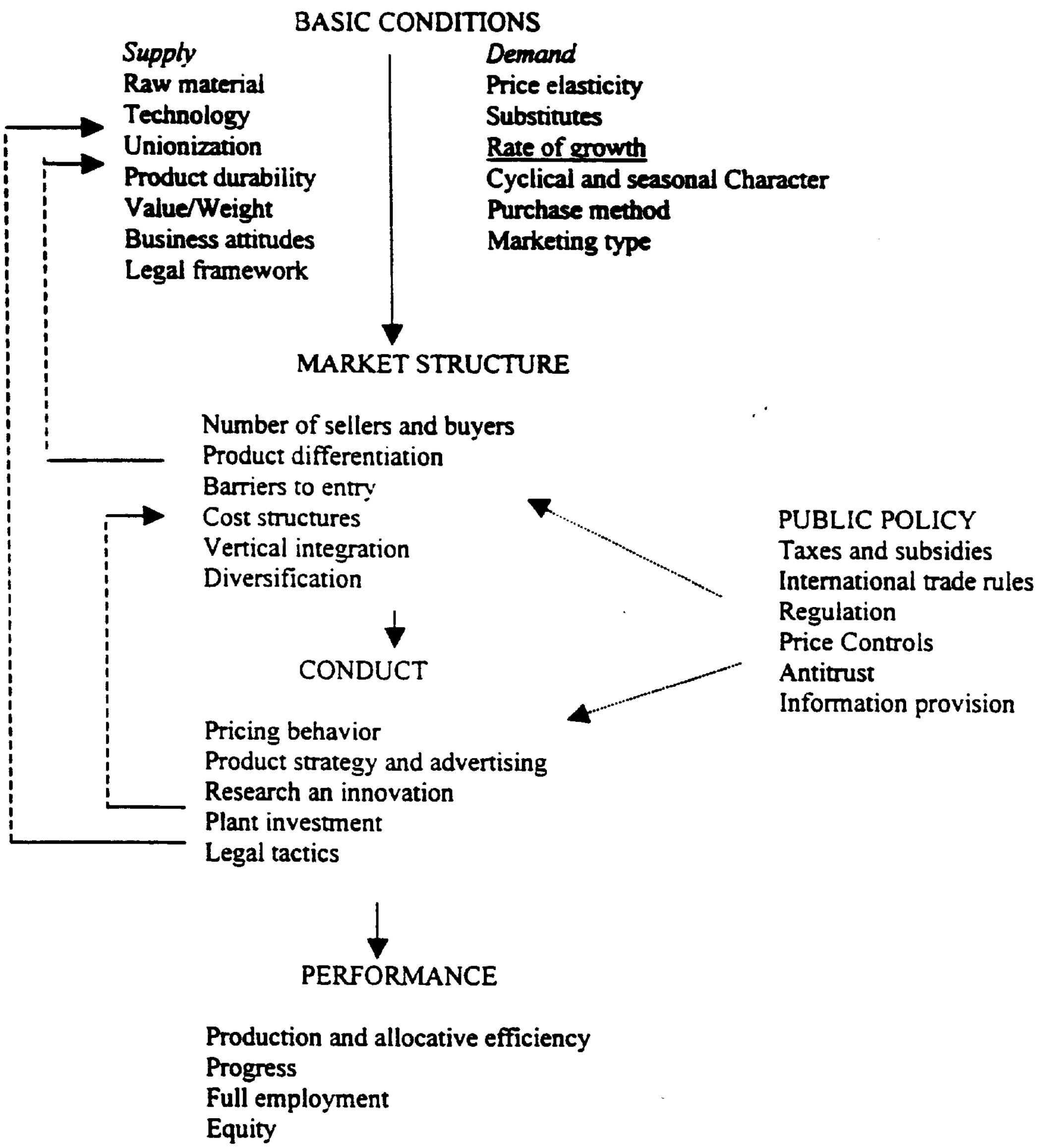
[62] The Consumer Federation of America has applied a similar analysis to a variety of "network" industries including Consumer Federation of America. *Stonewalling Local Competition: The Baby Bell Strategy to Subvert the Telecommunications Act of 1996* (Consumer Federation of America, January 1998); *Open Skies Closed Airports* (Consumer Federation of America, February, 1997; *Economic Concentration and Diversity in Broadcast Media* (Consumer Federation of America, November 1995); *The Economics of Deregulation and Reregulation in the Cable Industry: A Consumer View* (Consumer Federation of America, September 1992), "Statement of Dr. Mark N. Cooper," *In re: Petition of Consumers Union and the Consumer Federation of America to Update Cable TV Regulation and Freeze Existing Cable Television Rates*, MM Docket Nos. 92-264, 92-265, 92-266, September 22, 1997; and Consumer Federation of America and Consumers Union, *Residential Consumer Economics of Electric Utility Restructuring* (1998), *Electricity Restructuring and the Price Spikes of 1998*, June 1999; Consumer Federation of America and the Media Access Project, *The Consumer Case Against Microsoft* (October 1998).

[63] Shepherd, William, G., *The Economics of Industrial Organization* (Prentice Hall, Engelwood Cliffs, N.J., 1985), p. 5, presents a similar view.

[64] Scherer, F. M. and David Ross, Industrial *Market Structure and Economic Performance* (Boston, Houghton Mifflin: 1990), p. 4.

> We seek to identify sets of attributes or variables that influence economic performance and to build theories detailing the nature of the links between these attributes and end performance. The broad descriptive model of these relationships used in most industrial organization studies was conceived by Edward S. Mason at Harvard during the 1930s and extended by numerous scholars.

EXHIBIT 5
THE STRUCTURE-CONDUCT-PERFORMANCE PARADIM



SOURCE: Scherer and Ross, F. M., and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifflin Company: Boston, 1990), p. 5.

In SCP analysis the central concern is with market performance, since that is the outcome that affects consumers most directly. The concept of performance is multifaceted. It includes both efficiency and fairness.[65] The measures of performance to which we traditionally look are pricing and profits. Pricing and profits address both efficiency and fairness. They are the most direct measure of how society's wealth is being allocated and distributed.

The performance of industries is determined by a number of factors, most directly the conduct of market participants. Do they compete? What legal tactics do they employ? How do they advertise and price their products? [66] The fact that conduct is only part of the overall analytic paradigm is important to keep in mind.

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[65] Scherer and Ross, p. 4.

> We begin with the fundamental proposition that what society wants from producers of goods and services is good performance. Good performance is multidimensional... Decisions as to what, how much and how to produce should be efficient in two respects: Scarce resources should not be wasted, and production decisions should be responsive qualitatively and quantitatively to consumer demands.
>
> The operations of producers should be progressive, taking advantage of opportunities opened up by science and technology to increase output per unit of input and to provide consumers with superior new products, in both ways contributing to the long-run growth of real income per person. The operation of producers should facilitate stable full employment of resources... The distribution of income should be equitable. Equity is notoriously difficult to define, but it implies at least that producers do not secure rewards in excess of what is needed to call forth the amount of services supplied.

[66] Scherer and Ross, p. 4.

> <u>Performance</u> in particular industries or markets is said to depend upon the <u>conduct</u> of sellers and buyers in such matters as pricing policies and practices, overt and taciturn interfirm cooperation, product line and advertising strategies, research and development commitments, investment in production facilities, legal tactics (e. g. enforcing patent rights), and so on.

Conduct is primarily a product of other factors. Conduct is affected and circumscribed by market structure. Market structure includes an analysis of the number and size of the firms in the industry, their cost characteristics and barriers to entry, as well as the basic conditions of supply and demand.[67]

Regardless of how much weight one gives to the causal assumptions of the paradigm, giving more or less weight to basic conditions or market structure, the list of variables is important. These are the factors that make markets work.[68]

B. MERGER ANALYSIS IN THE SCP PARADIGM

Mergers are an especially important event in the analytic paradigm because they rapidly and, in some cases, significantly alter the supply-side of the market.

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[67] Scherer and Ross, p. 5.

> Conduct depends in turn upon the structure of the relevant market, embracing such features as the number and size distribution of buyers and sellers, the degree of physical or subjective differentiation prevailing among competing seller's products, the presence or absence of barriers to entry of new firms, the ratio of fixed to total costs in the short run for a typical firm, the degree to which firms are vertically integrated from raw material production to retail distribution and the amount of diversity or conglomerateness characterizing individual firms' product lines.
>
> Market structure and conduct are also influenced by various basic conditions. For example, on the supply side, basic conditions include the location and ownership of essential raw materials; the characteristics of the available technology (e.g. batch versus continuous process productions or high versus low elasticity of input substitution); the degree of work force unionization; the durability of the product; the time pattern of production (e.g. whether goods are produced to order or delivered from inventory); the value/weight characteristics of the product an so on. A list of significant basic conditions on the demand side must include at least the price elasticity of demand at various prices; the availability of (and cross elasticity of demand for) substitute products; the rate of growth and variability over time of demand; the method employed by buyers in purchasing (e.g. acceptance of list prices as given versus solicitation of sealed bids versus haggling); and the marketing characteristics of the product sold (e.g. specialty versus convenience shopping method).

[68] Scherer and Ross, p. 6.

> We have saved for separate treatment a set of particularly important market structure-shaping forces – mergers, takeovers, and other legal transformations through which two or more formerly independent firms come under common control...
>
> Few topics in industrial organization economics arouse more passionate debate than mergers and takeovers. Some see mergers as an important source of efficiency; others emphasize their prominence as an outlet for managerial empire-building instincts whose pursuit degrades, not enhances efficiency; still others focus on mergers' role in altering market structure and enhancing monopoly power.[69]

Given the passionate debate over mergers, it is not surprising to find that mergers in general, and vertical integration through merger in particular, have come to be governed by a "rule of reason" or case-by-case approach in contemporary economic and legal analysis.[70] Because arguments can be made both for and against vertical integration through merger, in particular, economists and antitrust authorities judge each merger based on the facts of the specific case.[71] They weigh claimed efficiency gains against likely harm to competition. They ask whether the efficiencies could be achieved in other ways that would not harm competition at all. When mergers are vertical, they are particularly concerned about the level of competition in each of the affected markets and the impact of the merger on competition across stages of production.

AT&T has offered up all of the textbook claims about the positive effects of its

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[69] Scherer and Ross, p. 153... 198.

[70] Scherer and Ross, pp. 450-458, on the "Emergence of a Rule of Reason."

[71] Asch, chapter 14.

proposed merger and why competition will not be harmed.[72] This paper takes the opposite view.[73] As we go through the economic and legal discussions, we finds that under specific circumstances mergers are consistently likely to reduce competition and impose a cost on the public.

The horizontal problem presented by the AT&T/MediaOne merger is clear as noted in the previous chapter. A good case can be made that the merger violates horizontal standards or raises serious antitrust concerns in each of the stages of production – cable and Internet programming, cable and broadband distribution, and set top boxes. Horizontal concentration, the result of horizontal mergers, has been the most suspect type of merger activity.[74]

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[72] AT&T Corp. and MediaOne Group, Inc., "Applications and Public Interest Statement," *In the Matter of Applications for Consent to Transfer of Control of Licenses*, before the Federal Communications Commission

[73] As noted above, our arguments are generally associated with the structure conduct performance paradigm, which is in contrast to the Chicago school approach. There is little dispute that horizontal mergers can have negative consequences. Vertical mergers are more hotly debated but the central conclusion of SCP paradigm is that, as Scherer and Ross conclude "Our analysis reveals that under plausible circumstances, vertical integration downstream by an input monopolist can lead to enhanced monopoly power and price increases (p. 525)..

Scherer and Ross further identify specific factors that render the conclusion an open question (pp. 522…523).

> One answer is that the world is a good deal more complex than assumed in the models generating the Chicago propositions. In particular, those models ignore the possibility of substitutions between monopolized and competitive upstream inputs. Relaxation of the simplifying assumptions shows that monopoly power may be (but is not necessarily) enhanced through vertical combinations…
>
> However, there is also a minus that works contrary to the Chicago propositions. By extending its monopoly downstream operations, the integrated firm gains control over the downstream industry's use of all inputs, and not merely the use of input X. In addition to controlling the proportions in which X and Y are used, the integrated monopolist can determine the amount of previously competitive input Y used and hence increases its control over the amount of downstream output. The result may be restriction of output relative to the preintegration case, and thus an increase in the downstream product's price.

[74] Asch, Peter and Rosalind Senaca, *Government and the Marketplace* (Dryden Press, Chicago: 1985), pp. 192-195.

> The firm may simply buy out its rivals. merging with them to get a high combined market share for the new larger firm. Once unified, the former competitors no longer compete with one another.[75]
>
> The corporate merger is the ultimate form of collusion: when two firms merge they cease to have separate identities and act thereafter as a single unit...
>
> The horizontal merger [is] the most troubling form from a policy point of view (due to its effect on concentration) and the one that is subject to the closest scrutiny from antitrust authorities. The reason for economists concern with horizontal combinations can best be seen by exploring the relationship between industry concentration and price.[76]

It is also notable that the vertical aspects of the merger and related deals raise concerns. Exhibit 6 summarizes the anticompetitive conduct and negative market performance that can emerge from the weakened market structures that result from the particular type of concentration caused by the AT&T-MediaOne merger and its related transactions. These vertical impediments to effective competition are overlaid on the horizontal problems in the individual industries that the consolidation spans.

The proposed AT&T deal possesses each of the most troubling characteristics. As a result, we conclude that this merger has a high probability of imposing substantial harm on the public. The most succinct statement from the general literature that captures the problems with such a merger is from William Shepherd who concludes that:

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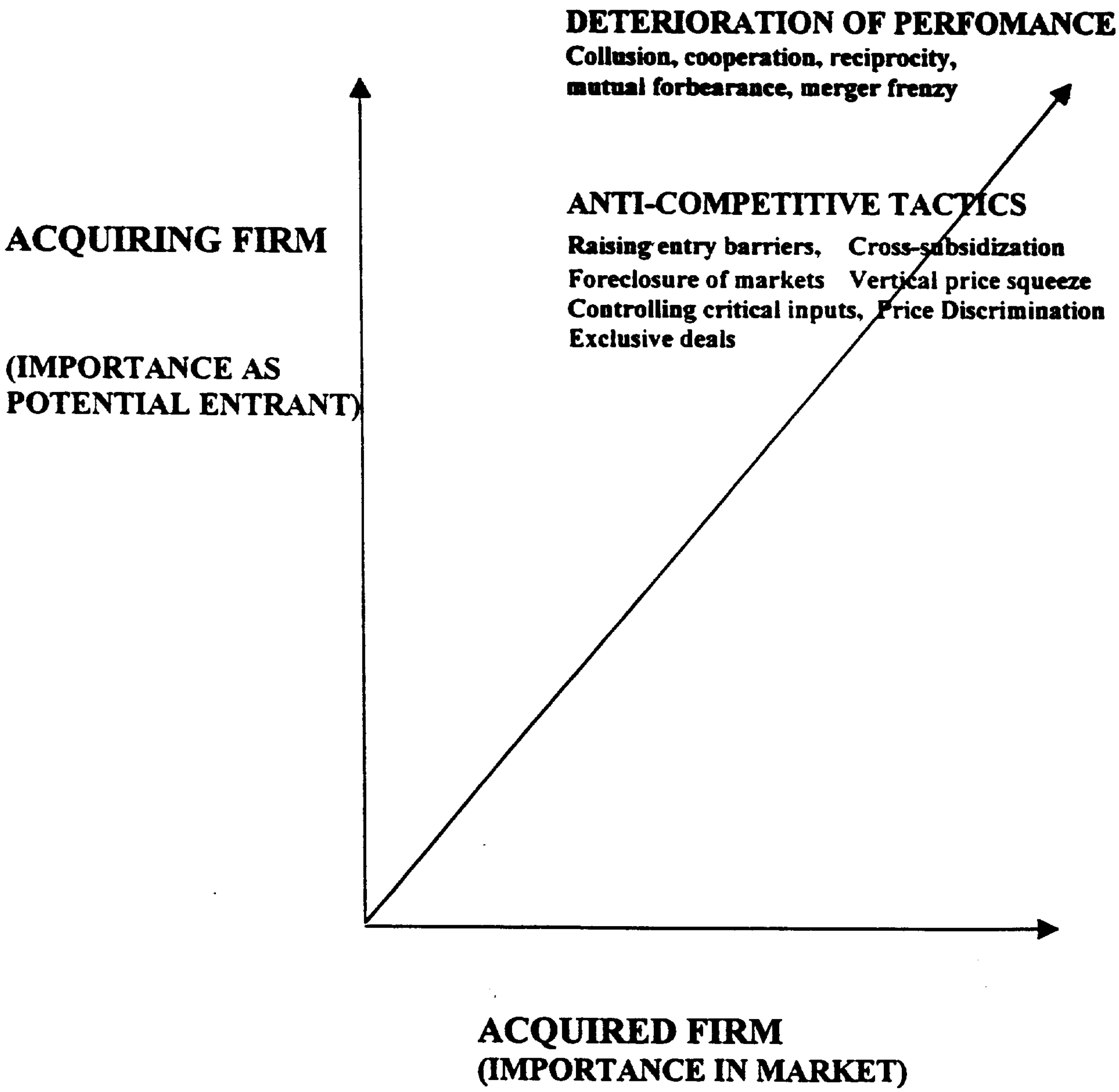
[75] Shepherd, p. 28.

[76] Jacquemin, Alexis and Margaret E. Slade, "Cartels, Collusion and Horizontal Merger," in Richard Schmalensee and Robert D. Willig, Eds., *Handbook of Industrial Organization* (North-Holland: New York, 1989), p. 430.

EXHIBIT 6:
THE SPECIAL PROBLEM OF CONGLOMERATES



Shepherd, William G. <u>The Economics of Industrial Organization</u> (Prentice Hall, Englewood Cliffs, N.J., 1985), pp. 289-304.

> The "ideal" conglomerate merger is by an unexpected entrant acquiring a minor firm. By contrast, if an important potential entrant buys up a dominant firm (or vice versa), competition will be doubly reduced.[77]

> Large costs could arise if the two merging firms are both heavily dominant at their levels, and capital barriers are high at one level.[78]

> In Chapter IV we demonstrate each of these vertical problems in the merger.

C. CONCEPTUALIZING AND MEASURING MARKET POWER

1. COMPETITION AND MARKET POWER

Measuring concentration for purposes of market structure analysis has received a great deal of attention. Market structure analysis is used to identify situations where a small number of firms control a sufficiently large part of the market as to make coordinated or reinforcing activities feasible. Through various implicit and explicit mechanisms a small number of firms can reinforce each other's behavior, rather than compete. Identification of when a small number of firms can exercise this power is not a precise science. Generally, however, when the number of significant firms falls into the single digits, there is cause for concern, as the following suggests.

> Where is the line to be drawn between oligopoly and competition? At what number do we draw the line between few and many? In principle, competition applies when the number of competing firms is infinite; at the same time, the textbooks usually say that a market is competitive if the cross effects between firms are negligible. Up to six firms one has oligopoly, and with fifty firms or more of roughly equal size one has competition; however, for sizes in between

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[77] Shepherd, p. 304.

[78] Shepherd, p. 292.

it may be difficult to say. The answer is not a matter of principle but rather an empirical matter.[79]

The clear danger of a market with a structure equivalent to only six equal sized firms was recognized by the Department of Justice in its Merger Guidelines.[80] These guidelines were defined in terms of the Herfindahl-Hirschman Index (HHI). This measure takes the market share of each firm squares it, sums the result and multiplies by 10,000.[81]

A market with six equal sized firms would have a HHI of 1667. The Department declared any market with an HHI above 1800 to be highly concentrated. Thus, the key threshold is at about the equivalent of six of fewer firms.

Another way that economists look at a market at this level of concentration is to consider the market share of the largest four firms (called the 4-Firm concentration ratio).[82] In a market with six equal sized firms. the 4-Firm concentration would be 67 percent. The

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[79] J. W. Friedman, <u>Oligopoly Theory</u> (Cambridge: Cambridge University Press, 1983), pp. 8-9.

[80] U.S. Department of Justice, <u>Merger Guideline</u>, revised, 1992.

[81] Shepherd, p. 389, gives the following formulas for the Hirschman Herfindahl Index (HHI) and the Concentration Ratio (CR):

$$H = \mathop{}_{i=1}^{n} p_i^2$$

$$CR_m = \mathop{}_{i=1}^{m} p_i$$

where
n = the number of firms
m= the market share of the largest firms (4 for the 4 firm concentration ratio)
p_i = the share of the ith firm.

[82] See note 59.

reason that this is considered an oligopoly is that with a small a number of firms controlling that large a market share, their ability to avoid competing with each other is clear.

Shepherd describes this threshold as follows:[83]

> Tight Oligopoly: The leading four firms combined have 60-100 percent of the market; collusion among them is relatively easy.

While six is a clear danger sign, theoretical and empirical evidence indicates that many more than six firms are necessary for competition – perhaps as many as fifty firms are necessary. Reflecting this basic observation, the Department of Justice established a second threshold to identify a moderately concentrated market. This market was defined by an HHI of 1000, which is equivalent to a market made up of 10 equal sized firms. In this market, the 4-Firm concentration ratio would be 40 percent.

Shepherd describes this threshold as follows:

> Loose Oligopoly: The leading four firms, combined, have 40 percent or less of the market; collusion among them to fix prices is virtually impossible.[84]

Shepherd also notes that a dominant firm – "one firm has 50-100 percent of the market and no close rival"[85] – is even more of a concern.[86]

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[83] Shepherd, p. 4.

[84] Shepherd, p. 4.

[85] Shepherd, p. 4.

[86] The Department of Justice Guidelines of 1984 had a dominant firm proviso, which was dropped in the 1992 update.

2. THE SPECIAL IMPORTANCE OF PREVENTING CONCENTRATION OF MARKET POWER IN COMMUNICATIONS MEDIA

Even the moderately concentrated threshold of the Merger Guidelines barely begins to move down the danger zone of concentration from 6 to 50 equal sized firms. For a "commodity" with the importance of telecommunications, certainly this moderately concentrated standard is a more appropriate place to focus in assessing the structure of the market.

The Bill of Rights established the principle that the press plays a special role in politics. Diversity of political ideas available through the public media is believed to be a cornerstone of vibrant and free political debate. While the print media dominated the first century and a half of American political life, the enactment of the Communications Act of 1934 extended the commitment of public interest obligations to the broadcast media. In fact, the concerns about the important role of mass communications have only been redoubled as electronic media have come to dominate political discourse and cultural value formation.

Because policymakers recognize the uniquely important role that broadcast media - radio and later television -- play in the marketplace of political ideas and in forming cultural values, they have imposed more explicit standards on the industry. Above all, policymakers have rejected the notion that economics alone should decide the nature, availability, and content of political and cultural programming. Instead, policy has sought to prevent concentration of economic power from controlling the flow of ideas in the broadcast media by placing limits on the ownership of media outlets and imposing obligations to expand programming beyond what is simply profitable.[87] In short, what is good enough in the economic marketplace has not been considered to be good enough in the political and cultural marketplace.

Almost three-quarters of a century of public policy toward the mass media have been predicated on the recognition of the uniquely powerful impact of that media.[88] Broadband Internet services takes the role of the broadcast media to a higher level adding interactivity to immense reach,[89] real time immediacy,[90] and visual impact.[91] Because it is such a potent method of information dissemination, economic control over mass media can result in excessive political power.[92]

In other words, in simple economic markets levels of concentration typified by 10 equal sized firms are high enough to raise questions about the competitive behaviors of the

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[87] The Federal Communications Commission, Further Notice of Proposed Rulemaking in the Matter of Review of the Commission's Regulations Governing Television Broadcasting, MM Docket No. 91-221, January 17, 1995, pp. 54-55).

[88] C. M. Firestone and J. M. Schement, Toward an Information Bill of Rights and Responsibilities (Aspen Institute, Washington, D.C., 1995), p. 45

[89] Bagdakian describes the economic and cultural impact of television as follows (p. 182):

[90] Gigi Sohn and Andrew Jay Schwartzman, "Broadcast Licensees and Localism: At Home in the 'Communications Revolution,'" Federal Communications Law Journal, December 1994; M. Griffin, "Looking at TV News: Strategies for Research," Communication, 1992.

[91] Kathryn Olson, "Exploiting the Tension between the New Media's "Objective" and Adversarial Roles: The Role Imbalance Attach and its Use of the Implied Audience, Communications Quarterly 42: 1, 1994 (pp. 40-41); A. G. Stavitsky, "The Changing Conception of Localism in U.S. Public Radio," Journal of Broadcasting and Electronic Media, 1994.

[92] P. C. Washburn, "Top of the Hour Radio Newscasts and the Public Interest," Journal of Broadcasting and Electronic Media, 1995, pp. 74-75.

> Widespread belief in economic competition as the foundation for a genuine "marketplace of ideas" was exploited effectively by the Reagan administration and by powerful corporations such as AT&T, ITT, General Electric, CBS, Capital Cities, and IBM to eliminate much of the regulatory structure of America's communications industry.

firms in the market. Given the nature of the telecommunications industry and the special concern about the free flow of ideas, this is a conservative level of concentration about which to be alarmed.

As demonstrated in the next chapter, by these standards, the AT&T deals pose a horrendous problem of concentration and presents a severe threat to the public interest.